THE INDEPENDENT TREASURY AND THE BANKS

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The relations which exist between our federal treasury and our banking system are in several respects unique. Our practice has been determined by political rather than commercial and financial exigencies, and in response to popular opinion molded by a vague dread of a money power. Strange to say, this public sentiment, so jealous of the safety and purity of the federal treasury administration, has not developed a consistently similar organization for any of our states or municipalities, nor can one find a precedent anywhere in modern Europe.

The normal relation between a public treasury and a bank or group of banks is exactly like the relation between any private firm or corporation and its banker. Such relation may be regarded normal since it persists throughout the United States with respect to the public funds of states and local organizations and throughout Europe with respect to national as well as local funds. Normally the bank is regarded as a place for deposit of revenue, and from it disbursements are made by check or draft. The deposited funds pass to the legal ownership of the bank and are used in any manner consistent with the prevailing rules and customs of banking, and the public usually holds in return the rights of a depositor and no more. With respect to the lending function of a bank the same analogy holds true. The properly authorized officials of the treasury may borrow in anticipation of revenue and pay interest proportioned to the nature of the loan, the character of the security and the state of the money market. The proceeds of the loan appear as a deposit subject to check and there is essentially no other effect upon the banker's assets, liabilities, reserves or lending power than would be felt in the event of similar transactions with a private corporation of equal magnitude.

For nearly three-quarters of a century the attitude of our gov-

ernment toward the banks has been one of distrust, and in the later decades this distrust has been associated with a peculiar paternalism. Not only are the banks regarded as incompetent to take care of the government business, but in a large sense they are regarded as unfit to attend to their own business, and they have been subjected to a system of regulation, both state and national, which grows more and more minute as the years pass. With this great mass of regulative law we are not concerned except where it involves the specific relation between the federal treasury and the banks. The significance of this suspicious and paternal attitude of the national government may develop in a discussion of the following propositions: First, the position of the treasury as contemplated in law and tradition is one of complete isolation. Second, the rigidity of this situation is in a measure relaxed by the practice of lending treasury funds to certain banks on collateral security. Third, the treasury undertakes to guarantee to a limited extent the current liabilities of national banks which own and are willing to hypothecate a special class of assets.

I. The Isolation of Treasury Funds

It would be superfluous to review the history of the independent treasury further than to remind the reader that it is an inheritance from the Jacksonian era in American politics. It does not bear the hall mark of any eminent financier. It was forced upon the country as the only consistent alternative of the victorious party in the unfortunate contest which humbled the Second Bank of the United States and made it a scapegoat. For almost twenty years the ideal of independence was strictly adhered to. When in 1861 Congress permitted the deposit in banks of the proceeds of certain government loans, the secretary of the treasury regarding the permission as an emergency measure did not see fit to use it, announced his adherence to the principle of the independent treasury and so established it all the more firmly. When in 1863 the founding of a system of banks under federal control made the original arguments for maintaining an independent treasury no longer valid, popular prejudice was too strong to permit the national banking system to come into the full estate which reason and considerations of economy would accord it. During the half century that has supervened Congress has enlarged the use of the banks as custodians of public money, but in no case has this use been made mandatory. The discretion has rested with

the administration surrounded with abundant and, in cases, humiliating safeguards.

Besides the treasury at Washington there are nine sub-treasuries in as many of the larger cities and fourteen mints and assay offices. It is the theory of our system that all funds of the government, on hand at any time, shall be actually stored in the vaults of these twenty-four institutions in the form of "money," that is to say, in coin, bullion, notes and certificates, as in the treasure chest of some mediaeval war lord.

Since our federal revenue is so largely derived from indirect taxation the streams rise and fall with the course of certain lines of trade and rarely coincide with disbursements over any considerable period. Owing to this uncertainty in the rate of income, there is nearly always a surplus and, normally, the excess of income over outgo determines the magnitude of the treasury hoard and the amount of the circulating medium of the country condemned to idleness. In the year 1899 receipts from all sources exceeded disbursements by $100,791,521, while in 1909 disbursements exceeded receipts by $118,795,919.[1] This indicates a range between the greatest surplus and the greatest deficit in a single decade of more than $219,000,000, and even in the year of greatest deficit there was at the close, exclusive of trust funds and the gold reserve, a balance of over $65,000,000 in the treasury offices. The largest cash balance actually held in the offices of the treasury at the end of any fiscal year in the last decade was $255,257,493 on June 30, 1907, and the smallest was $214,206,233 on June 30, 1900. These sums include the gold reserve and in both instances represent approximately ten per cent of the entire money circulation in the country.[2]

These sums are significant from the point of view of their absolute magnitude and also from that of their variability. In all cases they consist of money capable of use as bank reserves. It is true that national banks may not count banknotes as part of their reserves, but since such notes are used as reserve by state and private banks, the distinction may be ignored. It may be said also that the cash reserve of banks is made up of the surplus circulation of the country. So long as there is a deficiency of money for the needs of trade it will not be deposited, or if deposited will not remain in the

[1]Finance Report, 1909, p. 117.
[2]Finance Report, 1909, p. 233.

hands of the bank. It follows that this entire sum of over $200,000,000, if not held by the treasury, would be added to the bank reserves, eliminating exports of gold, and would increase the cash holdings of all institutions doing a banking business by about seventeen per cent on the average. The effect of such an increase in cash reserves would depend on various circumstances. In the case of some banks it would further establish the convertibility of their demand liabilities without affecting the magnitude of these liabilities. In the case of others, by increasing the lending power it would tend to decrease the rate of discount and so the cost of conducting business in general. This diminution in the costs of competitive business, other factors remaining constant, would tend to lower prices of consumers' goods.

The first and most obvious objection to our practice is found in the social loss involved in the idleness of pecuniary capital. At a time when the country is agitated over rising prices and waste of resources, it may be worth while to consider this item of extravagance in our fiscal system.

Position of Bank Reserves in the Credit System

The significance of the segregation of treasury funds lies in the relation of money to bank credits and the analogous relation of these bank credits to the extent of industrial and commercial operations. The credit system of the country has been compared to an inverted pyramid resting on a relatively small volume of money and subject to alternate contraction and expansion with every variation in the volume of the money support. In so far as credit applies to the demand liabilities of the banks the illustration is apt enough, but as applied to credit as a whole it is not quite adequate. The deposit liabilities of the central reserve city banks approximate four times their stock of lawful money under ordinary commercial conditions. But these deposits in turn may represent half the reserves of reserve city banks where lawful money may legally and practically support a volume of deposit credit eight times its magnitude. But the deposits in reserve centers may constitute reserves for a much larger number of country banks and trust companies, in which a given volume of actual money may support liabilities varying from ten to twenty times its magnitude. When we include in our concept of a credit system the obligations of business men and firms whose

"cash" reserves consist entirely of deposits subject to check it will be apparent that the structure of such a system is rather like an inverted bell with widely flaring rim.

The banking business socially viewed is not an end in itself. It is essentially a device for liquidating private credit. The most important function of a bank is to exchange its own credit capable of ready circulation for private credit which lacks that quality. Indeed, if the notes and acceptances of individuals and firms could have the general acceptability of bank obligations no use would remain for the common commercial bank. Practically all the assets of a bank under the head of loans and discounts consist of these sound but relatively sluggish forms of credit and over against these stand its own deposit liabilities. Since many private credit transactions never get into bank, it follows that the total volume of commercial credits is greater by far than the aggregate loans and discounts or resulting deposits of the banks.

Even though many credit transactions may be settled without resort to cash funds, the fact remains that the safety of the debtor is measured by the certainty of his ability to convert his own goods or credit into bank credit at or before the maturity of his obligation. It follows that the great body of bank patrons are as vitally interested as the banker himself in any influence which affects the ability of the banker to perform his function. On the assumption that private obligations offered for discount are fully secured with respect to their ultimate discharge, the ability of the banker to serve his customer is only limited by the relation of his money supply to the volume of his own liabilities and the rate at which he may be called upon to discharge them. It appears, therefore, that the public is vitally concerned with all factors which bear upon the magnitude and stability of bank reserves, since every man's solvency depends on his ability to meet with reasonable promptness his maturing obligations. The safety of the merchant may be in jeopardy not only when the banker fails to pay his check, but just as truly when he is unable to discount his secured paper.

The waste involved in the idleness of public funds is less objectionable than the successive expansion and contraction of reserves which result from the receipt and disbursement of revenue. One phase of this movement may be illustrated by the simple case of a pension disbursement. On August 4th the treasury drew pension

checks amounting to $14,970,000, and distributed them throughout the country. About half of this sum was drawn upon the assistant treasurer at New York. Coming into the hands of country banks, cashed or deposited, these checks are mailed to New York correspondent banks for credit. In a few days this mass of checks is presented to the New York sub-treasury through the clearing house and an equivalent amount of money is transferred from the sub-treasury to the banks whose combined reserves, in the absence of countervailing debits, are increased $7,000,000. Without any alteration in the aggregate wealth of the country or even of New York City the lending power of New York banks is raised about $28,000,000. In order that this new source of profit may be utilized, since nothing in the situation operates immediately to stimulate the demand from commercial sources, the competition of banks in an effort to place their funds lowers the call loan rate. This reduces the cost of carrying stocks and stimulates speculation for the rise in Wall Street.

To reverse the illustration let us suppose that the collection of duties at the port of New York in a given week reaches the not uncommon sum of $10,000,000. This amount of money is drawn from local banks and trust companies and locked up in the sub-treasury. In as far as the effect on reserves and lending power is concerned, it might quite as well have been sunk in New York harbor. The rate for call loans rises, stocks fall or commercial paper which otherwise would have found a ready market remains unsold and the production and exchange of goods may be curtailed.

Unable to foresee these fluctuations in reserves and the consequent fluctuations in the lending power of his banker, the merchant is constrained to carry a much larger cash reserve (bank deposit) than would be carried otherwise, and the interest on this is the price he pays for this particular form of insurance, a charge that is ultimately shifted to the consumers of the goods he offers for sale or to the producer from whom he buys. By the same token, each banker in a system which presupposes independence and the absence of any joint responsibility, carries a large fund of capital devoted to no more productive purpose than as an insurance fund. This fund of ready money tends to be largest in times of stress when the needs of commerce are greatest. Witness the abnormally large reserves carried by country banks on the occasion of the report to the comp-

troller on December 3, 1907. This added cost to the banker's business is paid in higher discount rates and tends to shift to the price of commodities.

Disadvantages Culminate in New York

These movements of money from a state of vitality to one of inactivity take place in every locality provided with a sub-treasury, but they are most significant in New York. In the clearing house there the daily balances are settled in United States notes or gold certificates. The net result of these clearing operations in the month of November, 1907, was a loss for the banks of $12,000,000, and in December it was $4,000,000 more. That this movement of money tended to increase rather than allay the prevailing anxiety no one can doubt. During 1908, when business was depressed and loanable funds abundant, the net result of clearings was a gain to the banks in every month. The largest gain was in April, when $40,000,000 was added to New York bank reserves, and the smallest was in September, when over $16,000,000 was transferred from the treasury to the banks. The total gain of the New York banks from the treasury in this year of low revenue and large disbursement was over $384,000,000. While the banks were gaining in New York they were often losing to the treasury at other points, but the net gain of banks in general was great and the effect in New York was seen in the remarkable bull movement in stocks which began in the spring and culminated just before the death of Harriman, in August, 1909.

The largest source of revenue is in the import duties, amounting in the fiscal year just closed to $333,683,445.03. About two-thirds of these duties are paid into the sub-treasury at New York mainly from the banks of that city, and a correspondingly large part of the disbursements are made from that sub-treasury and pass to the local bank reserves. It happens that gold drawn for export is taken as a rule from the same group of banks. New York bank reserves stand in a peculiar relation therefore to our foreign trade. When imports of commodities are heavy, as they have been during the past fiscal year, the payment of duties tends to coincide with a rise in foreign exchange and threatened or actual gold exports causing a double drain of bank reserves. In this situation, it would be suicidal for New York bankers to purchase time paper with the same liberality as can be practiced by the bankers of Chicago or St. Louis. In

order to protect themselves against this double drain of funds they must lend a large portion of their credit on call or adopt the alternative policy of excessive reserves. That is to say, the ordinary stock exchange loan is utilized as an auxiliary reserve in New York much as the investment in New York exchange constitutes an auxiliary reserve for the country bank. Whatever may be thought of the expediency or morality of the stock exchange loans which represent more than a third of the credit assets of New York banks, the relation of our fiscal system to the case is obvious.

The arguments which led to the segregation of public funds before the Civil War have no force to-day. The most important purpose in establishing the independent treasury was to secure the safety of funds which, on the expiration of the charter of the Bank of the United States, were deposited in state banks. Over these institutions the government had only indirect control and the states exercised but little or none. Whether the state banks of that day were worthy of confidence need not be debated now. The situation was radically changed by the establishment of national banks, and has gradually improved as the banking business has been more fully understood and as comptrollers of the currency have developed an increasingly effective body of administrative regulations. During the last forty years the average loss to depositors in national banks has been but .0807 of one per cent a year. Had all government funds been included among these deposits with no more protection than was accorded general creditors the loss during the year of largest deposits would have been about $205,000. While this is not a sum to be thrown away, it is less than half the annual salary budget of the treasurer's office. But when the government has intrusted any funds to the care of the banks it has assumed the rôle of a preferred creditor. Had the national banking system been treated from the outset as a fiscal agency with the government protected by a prior lien, losses from bank failures would have been negligible. The practice of the government, therfore, cannot commend itself to-day on the ground of either safety or economy.

Another reason for the isolation of public funds was the possible political corruption that might arise from an alliance between private corporations of great power and the fiscal establishment. Whatever ground there may be for such a fear must be in the memory of the political machinations of the Bank in Jackson's first

term, when the officers of that institution, put upon the defensive, unwisely accepted the challenge of the President. There was nothing in the history of the first bank to warrant such a fear, nothing in the first sixteen years of the second one. Every state and municipality in the country deposits its funds in banks and the aggregate of these public funds is great. The writer has never heard a charge of political corruption beyond such as grew out of the rivalry between institutions competing for the custody of funds. This situation would not arise where a bank or group of banks had been established with specially defined fiscal functions as is the case in Europe generally. A method may long survive its usefulness without objection if indeed it be harmless. From this point of view the independent treasury is open to attack. It is not harmless nor merely wasteful. It establishes an irreconcilable antagonism between the commercial interest and the fiscal interest in the circulating medium. We have been extremely zealous that Cæsar may get Cæsar's and forget that the money of the country has another and generally more important function than to serve as the material embodiment of the assets of one of our public treasuries.

II. The Lending of Public Funds to Banks

The funds of the federal treasury arise from every nook and corner of the country, as one must realize by a thought of the ramifications of the postoffice alone. Notwithstanding the number of sub-treasuries, mints and assay offices, the convenient conduct of government business has necessitated other places of deposit and disbursement, and 418 national banks are now designated as regular public depositories. The Secretary of the Treasury selects these banks and indicates the sum which each may hold as determined by the fiscal operations on hand or contemplated in that locality. These banks, unless special arrangements are made, must transfer to the treasury all public money received by them in excess of the limit fixed by the secretary, and these transfers, together with any others made in the course of public business, must be made at the expense of the banks involved. While the banks must give acceptable security for the deposits so held, they do not pay interest upon them nor treat them in any other way as different from private deposits subject to check. At the end of the fiscal year just closed deposits of this character amounted to $51,536,236.30, held to the credit of the

Treasurer of the United States and to that of the various disbursing officers, except postal funds, which are under control of the Postmaster-General. Until 1902 the security held by the government was in the form of its own bonds, but since that date other bonds, such as are legal investment for savings banks in New York, New Jersey, Massachusetts and Connecticut, are accepted as security.

The relation between the treasury and the depository banks may be regarded as normal and may need no comment. In so far as public funds are so held, our treasury policy is free from the criticisms that have been set forth above.

In addition to these regular depositories, 963 national banks are privileged to hold what are called "special deposits" of public funds, and it is these funds which are properly regarded as loans. They are solicited by the banks; they bear interest at the rate of one per cent per annum, since June 30, 1908; they are secured by collateral and they are made payable at a specified time, or on reasonable notice. These loans differ from true deposits in that they are exempt from the legal reserve requirements. These funds are equivalent to a temporary increase in banking capital and serve to augment reserves instead of constituting a burden upon reserves as is the case with deposits in the true sense.

The sums so held by banks are subject to wider variation than those held in the treasury offices. The largest sum loaned in this manner during the last decade was $256,920,155, in December, 1907, while the smallest was in the year just closed, the amount of so-called special deposits on June 30, 1910, being but $4,144,000.

The method employed in these operations may best appear from the words of the Treasurer in his report for 1909:[3]

The balance in banks to the credit of the general fund on October 31, 1908, was $120,279,145.98. Owing to the large disbursements made from the treasury not equaled by income, the Secretary of the Treasury on November 18th issued a call to 839 special depository banks throughout the country for the return to the treasury by each on or before November 30th, of $5,000 of the public moneys deposited therein. . . . The balance in banks to the credit of the general fund was reduced to $113,578,810.64 by December 3d and decreased slowly thereafter until the close of December, when it became $110,148,907.30. Early in January (1909) it became apparent from the large disbursements being made that it would be necessary to recall to the treasury additional deposits from banks, and accordingly the Secretary on January 11th

[3]Finance Report, 1909, p. 144.

issued a call to the depository banks throughout the country for a return to the treasury of a part of the public moneys deposited with them payable as follows: On or before January 23d, $17,717,700; on or before February 10th, $6,804,060.

The transfer of funds to and from the banks is made in lump sums roughly corresponding to the relation of income to disbursement, but at any particular moment at the arbitrary discertion of the Secretary. Since an ample working balance is kept in treasury offices, the public generally is unable to tell when these pseudo-deposits will be called or when they will be increased. The result is a speculative uncertainty which neutralizes in a great measure the benefit sought to be given by the distribution of otherwise sequestered funds. The scheme is not automatic in its operation and does not respond immediately either to fiscal or to commercial conditions. A characteristic sentence from the money market column during last winter ran as follows: "Stocks opened strong at fractional advances over last evening's close, but a persistent rumor that the treasury was about to make a call on the banks induced selling and the close was weak with losses of a point or more all over the board."

During the somewhat drastic liquidation running through the year 1907, repeated appeals were made to the treasury for funds, and these were interspersed with protests against withdrawals. The secretary seems to have accepted this new responsibility as a monitor of the money market, and responded to all such calls as the surplus revenue made possible. When the pressure on the banks reached the panic stage in November, the limit of public aid had been reached. Then followed that most remarkable proposition to sell $100,000,000 in three per cent treasury notes for the express purpose of relieving the straitened situation into which the dealers in private credit had allowed themselves to drift.

Prior to the administration of Secretary Shaw the placing of special deposits had taken place with reference to the needs of the treasury, at least such was the common impression. But in 1906 the Secretary in his annual report announced the doctrine that his office should frankly accept the duty of regulating the money market by judicious distribution or withdrawal of public funds. He says:

If the Secretary of the Treasury were given $100,000,000 to be deposited with banks or withdrawn as he might deem expedient, and if in addition he were clothed with authority over the reserves of the several banks, with power to contract the national bank circulation at pleasure, in my judgment no panic, as distinguished from industrial stagnation, could threaten either the United States or Europe that he could not avert. No central or government bank in the world can so readily influence financial conditions throughout the world as can the Secretary of the Treasury under the authority with which he is now clothed.[4]

This remarkable and ambitious program did not attract very wide attention at the time it was announced, but the events which immediately followed give it a place of historical importance along with the actions of Secretaries Boutwell and Richardson, and the pronouncements of Spaulding and Butler in the old greenback days. The report had hardly come from the bindery before one of those historic periods of liquidation had begun. "The authority with which the Secretary is now clothed" was appealed to with the result that public deposits were expanded to the extent of over $200,000,000 to be followed by a "panic in distinction from industrial stagnation" of the most typical sort.

It is impossible to believe that any special powers of regulation or any special funds in the hands of the Secretary for that purpose could have affected the situation substantially. The policy of Secretary Cortelyou was in full accord with that of his predecessor. Public funds were unusually abundant and these were nearly exhausted by efforts at relief in the preliminary stages of liquidation, so that when the crash did come in October, little was left but a fiat, an instrument which fortunately has ceased to be invoked since the resumption of specie payments.

So long as we must adhere to the principle of the independent treasury and a policy of surplus financiering, it is doubtless well to permit the deposit of special public funds. The arbitrary doling of these funds to banks which bear no direct relation to the communities from which the funds arise must be regarded as a lame expedient. Moreover, it must be dangerous to business interests to place on the shoulders of a Secretary a responsibility for which his training and experience may have given but indifferent equipment and to accord him the power to stifle or stimulate the growth of

[4] Finance Report, 1906, p. 49.

private credit with which his official position has no direct connection. In the long list of able men who have held that responsible position, there are not many to whom the business interests would readily accord such power.

There is no more reason why the members of the banking profession should stand before the public treasury hat in hand than that any other group of business men should do so. It is only a few years ago that a considerable political party was demanding that the government lend capital to the farmers on mortgage. Would it be any more preposterous for the Secretary to have a special fund from which he would anticipate the foreclosures which follow a season of poor crops than that he have such a fund with which to soften the fall of a structure of bank credits which is toppling under its own weight? At any rate, it may be said in favor of the farmers' contention that they were willing to pay two per cent for the accommodation.

Of course farm credits are not like bank credits, and the provision of a special fund has not been made in either case. Moreover, it may be said that the evils involved in treasury loans are less than the evils in the alternative of segregated public funds. Our experience here simply emphasizes the vices of the original system and enforces the principle that credit expansion cannot be controlled except from within the credit system and should not be subject to unnecessary disturbance from without. Credit rises out of conditions in the market for commodities, and it is in that same market that mistakes in credit must be righted. Men who misjudge the market and so borrow or lend too much must suffer the process of correction as truly as must the farmer who realizes that he should have planted corn where he sowed his oats. The money market which is devised to perfect the operations of the commodity market is an extremely complicated and delicate machine and operates automatically. Those who buy and sell there and assume the responsibilities attending their own activity, in the absence of monopoly or fraud have a right to freedom from paternal manipulation, however well intended.

III. The Federal Guaranty of Bank Notes

The third peculiar feature in the relation of the treasury to banks is found in the virtual guaranty of the banknote liability.

This guaranty is not expressed in terms by the law, but is accomplished no less effectively by being indirect. The law places a prohibitive tax upon all notes of banks except such notes of national banks as are furnished in blank by the Comptroller of the Currency. No such notes are furnished except upon application of a bank depositing with the treasurer, United States or other acceptable bonds or depositing other securities with a national currency association under conditions laid down in the act of June 30, 1908. Any of these notes when properly signed and issued by the bank are acceptable for all payments to the United States, and through such acceptance the government guaranty is affected.

The volume of notes outstanding on June 30, 1910, was \$713,430,733; all of these are secured by the deposit of United States bonds, since no banks have as yet availed themselves of privileges of further issue provided by the law of 1908.

The history of our national bank currency is too well known to be recounted here further than to say that like the independent treasury itself it grew out of conditions that are wholly passed away. These conditions were first a system of unrelated and poorly regulated banks on the one hand and the necessity for an extensive market for Civil War bonds on the other. In the absence of either of these conditions it is not likely that such a bank-note system as we have to-day ever would have been instituted. Once established the weight of inertia has been against a radical change. Moreover, the good features of the system—safety and uniformity in the currency—were so obvious and the evil effects so obscure that the public generally has shown but little response to the preaching of reform.

In a broad and general way the objections to our system of note issue are summed up in the term "inelasticity," and this inelasticity results from the measures which the government adopts to protect itself and justify its guaranty. Not only is it true that the volume of notes in the aggregate does not rise and fall with the varying need for a circulating medium in the country at large, but more important still the issues of a particular bank cannot be adapted to the needs of its particular patronage. Associated with this failure to respond to the needs of trade is another quality open to condemnation; that is the quality of expansion and contraction in response to the state of the bond market as distinct from that of the commercial credit market.

With respect to the note issues as a whole, it will be recalled that every national bank must own and deposit with the government a minimum portion of its capital in government bonds. Banks which have no real need for notes seldom fail to utilize this compulsory bond deposit for an issue of notes. For all purposes save as a reserve against deposits this minimum note issue is in effect a replacement of banking capital forced by the banking law to take the form of a relatively unprofitable investment.

Assuming that a bank is founded for the purpose of earning profits in the banking business and that the capital originally contributed corresponds to the banking needs of the particular patronage to be served, the effect of the law is to force an unnecessarily large capitalization. And this is coincident with an inflation of the circulating medium, to the extent that notes are issued against the enforced deposit.

Coordinate with this force which makes for inflation is the absence of any effective and automatic machinery for contraction. There is but one redemption agency and that is at Washington, well removed from the ordinary channels of trade. The great volume of circulation never reaches Washington save as it is withdrawn from the course of trade and expressed at considerable expense. No distant bank has any adequate motive for incurring that expense except when notes are worn and mutilated. The result is that this circulation has largely lost its character as a demand liability of the banks and amounts to a virtual exchange of government notes for government bonds. If the government should issue $700,000,000 of legal tenders, put them out in the redemption of its own bonds, the situation with regard to the circulation of the country would be but slightly different from what we have. Such is the aspect which the note issues take when viewed as a whole.

With respect to particular banks and particular communities, the objections to our practice are even greater. It has been shown that the object of a bank is the purchase of private credit in forms unadapted to general circulation by giving in exchange its own credit in forms that are adapted to general circulation. These forms are the note and the checking account. If the bank is left to its choice it will use either the note or the deposit or both, as its customers demand. Since the aggregate of its liabilities is practically limited to the aggregate of private paper offered for discount, any limita-

tion on its power to contract obligations operates as a limit on its power to discount or afford accommodation.

Since there is in this country no legal limit to the deposit-liabilities, save in the reserve requirement, those communities which habitually use checks and have no use for notes find their banking facilities also unlimited except as by reserves. On the other hand, those communities accustomed to money payments find their banks shackled by the maximum limit to the note liability on the one hand and burdened by an unprofitable bond investment on the other. The significance of this may be clear by the experience of a country bank in the West with $100,000 cash capital. If the community uses checks instead of money, this $100,000 will support loans and consequent deposits of at least $400,000. If, however, it is a money-using community, the bank must invest its money in bonds and extend its liabilities in the form of notes to a maximum of $100,000. That is, in so far as the bank's patronage insists on using money rather than checks, to just that extent the bank's lending power is diminished by three-fourths. Putting the matter in another way, under our system of note issues, in so far as notes are actually demanded by the patrons of banks, we must devote four times the capital to the banking business that would otherwise be required. It is needless to comment on this waste of banking capital and its social significance. Fortunately the use of checks is gradually extending and the burden forced upon us by an unscientific system is growing less under normal business conditions. However, the inconvenience of tight money seasons and the high rates exacted of borrowers at such times are the price we pay for this survival of an ancient régime.

Reports of the comptroller frequently discuss the "profit on circulation" coming always to the conclusion that any such profit is small but real. Such a conclusion would seem to answer the arguments of those who object to the system on the ground that banks earn excessive profit on their notes, as well as of those who object because there is no profit in the notes. The merit of all such discussion turns on the meaning of profit. As against capital lying idle, of course there is a profit in using it as the basis of a national bank note issue. As against the same amount of capital used as a reserve against deposits there is a very real loss on all the capital used as the basis of a national bank-note issue.

As capital engaged in the separate departments of any business enterprise seldom earns the same returns, but is distributed to the departments in such manner as is supposed to yield the most on the whole, just so our national banks, except for the legal requirement of a minimum bond deposit, invest as little in the note issuing function as is consistent with the demands of patronage and as much in the extension of deposits as the same conditions justify. While in Europe to-day, as in America before the war, it is quite possible to conduct a safe and profitable banking business in which all liabilities take the form of notes; such an institution could not survive in this country at all under our national banking law.

That the note issue is generally on the margin of profitableness is evidenced by these facts. Many issues are at or near the minimum bond deposit. A few banks maintain their bond deposit and do not issue any notes at all. State banks without the right of issue compete successfully with national banks in the same communities and substantially the same class of business. As a result of the essential unprofitableness of note issues the total volume of notes rises with any fall in the market price of government bonds and falls with a rise in price of these securities. In the latter case banks retire circulation, retrieve the bonds and sell them for the premium.

One of the worst features of our present system is the fact that it beclouds public understanding of the banking business, especially of the note-issuing function. After forty years of this sort of paternalism it is not strange that a considerable body of persons take the next plausible step and demand that the government guarantee the convertibility of the deposit liability as well.

More recently, as so-called deposits of government funds have constituted a significant temporary addition to the banking capital, there has been a tendency for the note circulation to rise as the deposits decline. The bonds, having been held for security of special deposits, are often left in Washington as a security for new notes. In so far as the new notes are used as reserves by state banks, this change in the national bank liability from the form of public deposits to that of notes may serve to prevent the contraction of credit which would have resulted from the withdrawal of deposits alone.

The foregoing objections to the bonds as the basis of bank

note issues are not removed by the Aldrich-Vreeland Act of 1908. While the new law admits of circulation based on commercial paper, its issue is hedged about by such safeguards as would make it available only in the most acute emergencies. In the first place, no bank can issue notes on this plan except it have outstanding circulation based on bonds to the extent of forty per cent of its capital stock. The amount it may then issue against commercial paper must not exceed thirty per cent of its capital and surplus. The rate of taxation on such notes is so high as to preclude possibility of profit on the issue, and an issue under such circumstances would be an acknowledgment of difficulties which no particular bank would willingly make. Finally, any bank choosing to avail itself of the new privilege of issue must not only convince the currency association to which it belongs of the necessity of such action, but must convince the Secretary of the Treasury as well, for with him lies the final discretion as to the expediency of the proposed increase in circulation. Manifestly, the machinery provided is too cumbrous for use in a real emergency if the law is to be obeyed in its letter and spirit.

The general subject of currency reform is not within the scope of this paper, but it may be said that no solution of that problem will be adequate which ignores the relation of the treasury to the banks. Whether the outcome be a central bank modeled on any of the plans proposed or simply a modification of the constitution and relation of existing independent banks, the treasury hoard must be abolished, the fiscal operations must cease to disturb commercial operations, and the Secretary of the Treasury must be relieved of responsibility for the money market.